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SUBJECT: SENATE TAKES UP 2010, WITH SENATORS DIVIDED OVER PROPOSED TAX INCREASES; A DEBT DOWNGRADE HANGS IN THE BALANCE

REF: MEXICO 2832

¶1. (SBU) Summary. As rating companies quietly consider downgrading Mexican debt, the Senate has now noisily taken up the Revenue Bill that the Chamber of Deputies amended and approved October 20. The Chamber had watered down the GOM's original proposal of modifying tax rates and tax laws designed to strengthen public finances and avert a credit rating downgrade. The Chamber scrapped the GOM's proposed 2% anti-poverty sales tax, but increased the VAT by 1% (to 16% and 11% at the border), keeping a zero rate for food and medicine. The Chamber also approved raising income taxes to 30%, up from 28%. Although the arithmetic of the Chamber's version covers the fiscal gap anticipated for 2010, it is significantly weaker and more ad-hoc than the GOM's proposal. It is doubtful that the measures are strong enough to avoid a ratings downgrade as this version stops short of providing a long-term solution to falling public revenue and will not help generate alternative income sources to replace the GOM's dependence on oil. The Senate has until October 31 to approve the revenue bill. End Summary.

¶2. (SBU) The Revenue Bill must now be approved by the Senate by October 31. After the bill was amended and approved in the Chamber, the consensus view was that the Senate was not going to introduce any significant modifications to the proposal. However, PRI senators rebelled against the tax package. The origin of the problem may be the attempt of PAN legislators - mainly PAN federal deputy and party president Cesar Nava - to blame the PRI for the VAT increase proposed in the lower house. Mexican economist Rogelio Ramirez de la O told Econoff that he believed 60% of the Senate's political complaints and threats were theatrics (towards the 2012 presidential elections) and 40% were real. At the end of the day what we will probably see are some modification/dilution to the Chamber's bill as has always been the case in past years. This year, however, the stakes are higher and the PRI - particularly the governors -- stand to lose more by further diluting the pending tax reforms.

The Chamber's Version

3.(U) On October 20, the Chamber of Deputies amended and approved the GOM's 2010 Revenue Bill. To gain the needed support from the opposition PRI, the GOM had to accept several changes in its tax package and income assumptions. The approved legislation forecasts MX$3.18 trillion (US$244 billion) in total revenue, slightly more than the GOM's original proposal. It calls for a wider deficit next year of 0.75 percent of GDP, compared with 0.5 percent in the GOM's proposal. It also increases estimated revenue by raising the benchmark oil price to US$59/barrel from US$53.90. The main

elements of the approved tax package follow below.
1% VAT Increase

¶4. (U) The general VAT will increase from 15 to 16% (and from 10% to 11% at the border). Food and medicine will remain at 0%. The legislation scraps the GOM's proposed 2% anti-poverty tax to all goods. According to Goldman Sachs, this change is expected to generate MX$34 billion (vs. MX$72 billion expected from the 2% anti-poverty tax).

Tax on Telcom Reduced

¶5. (U) The special tax (IEPS) on telecommunications was cut to 3% (from the GOM's proposed 4%). The tax hits fixed and mobile phones, pay-TV, and internet. Exempted from the tax are rural fixed-line telephones, public telephones, and intermediary, inter-connection charges (though end-users will sill be taxed). NOTE: Scattered press reports suggested that mobile calls would not be taxed. However, the "dictamen" and Secretariat of Communications and Transportation (SCT) contacts indicate mobile is not exempt. END NOTE. The VAT increase also applies, so the total tax hike to telecom is 4%.

¶6. (SBU) The telecom industry has fiercely protested this tax increase. They argue that telecom is an easy target as one of the few profitable sectors in this year's recession. They note that the 3% increase is regressive in that per-minute cell prices are highest for the poorer users who buy pay-as-you-go minutes. It is also likely to slow voice line penetration (currently 82% of population has mobile, fixed or both) and new investment in

infrastructure. Moreover, the tax includes a limited exception for rural fixed lines, deemed a basic service. But since the fixed line penetration rate in Mexico is less than 20%, the primary access path for many basic/low income users is cellular. Additionally, there is nascent protest across the internet, with many chat sites and Twitter users decrying the telcom tax as a further impediment to growing internet access, which is currently at an abysmally low 20-25% penetration across Mexico.

"Sin" Taxes

¶7. (U) The GOM's proposed IEPS increases on "sin" goods were also lowered somewhat:
-- The tax on alcoholic beverages will increase to 53% (from the current rate of 50%). (The GOM proposed to tax alcoholic beverages at 3 pesos per liter.)
-- The tax on beer will be 26.5% for 2010-2012, will decrease to 26% in 2013, and then return to the current rate of 25% in 2014. (The GOM proposed an increase of 28% in 2010, 2011, 2012; and a reduction to 27% in 2013; and a return to the current rate of 25% in 2014.)
-- Tobacco will be taxed at 0.10 pesos per 75 grams. (This is very similar to the GOM's proposal of a 0.0533 peso per gram tax.)
-- The rate on bets and gambling was increased to 30% (from the current rate of 20%). (Unchanged from the GOM's proposal.)

Income Tax (ISR)

8.(U) As proposed by the GOM, the highest marginal regular income tax rate (for corporations and individuals) will temporarily increase from 28% to 30% for three years (2010, 2011 and 2012), and would be reduced to 29% in the fourth year (2013), finally scaling back to 28% in 2014.

Fiscal Consolidation Changes

9.(U) The GOM's proposed limitations on tax deferment by conglomerates which use tax consolidation were reduced. Tax consolidation is a legal tool used by holding firms in which profits

and losses of their entities are consolidated and taxes are paid on the net result. The language in the current income tax law allows these firms to deduct losses of one of their subsidiaries against the profits of others. Currently, holding firms can defer tax payments due to existing loopholes in the current tax income law. In practice such firms were found to be deferring taxes indefinitely. A recent Tax Administration Service (SAT) report revealed that 4862 subsidiaries consolidated into 422 holding firms and paid on average 1.78% (rather than the 28%) over their sales in 2008 (see reftel A). The GOM's proposal was limiting deferment to no more than 5 years, so that firms would start in 2010 paying 60% of taxes deferred in 2005 and the rest in 4 subsequent years in equal parts. The lower Chamber amended the initial payment to 40% and the rest in four parts of 15% each.

10.(U) The business sector is particularly concerned about the changes to the tax consolidation regime. They complain that the changes do not give legal certainty to investors and are an excessive fiscal burden particularly for exporters. Mexico's leading business consortium, the Consejo Coordinador Empresarial (CCE) said it will file injunctions against the new tax consolidation regime and appeal to the Supreme Court. Many of the trade and business organizations are expected to lobby the Senate to eliminate these changes.

New Tax for Pemex

¶11. (U) Lawmakers also passed changes to tax rules for state-owned oil company Pemex aimed at promoting investment at new fields. Instead of applying different rates depending on the level of production, they approved a flat rate. They also introduced a new tax of 52% when the oil price exceeds 60 dollars per barrel. They also eliminated the differentiated tax regime for the Chicontepec wells (71.5%) and deep water projects (between 60-71.5%) and replaced it with a flat rate of 30%, which will increase to 36% whenever production exceeds 240 million barrels. The cap for

deductions will also be increased to boost investment. The oil extraction tax was also modified. The tax is currently 10% when the price is below US$40 and 20% when it is above US$60. The new flat rate is 15% on the value of oil and natural gas extracted in a year. According to both the GOM and Congress, these changes will give Pemex flexibility to invest more. (Note: The legislation did not include an estimation of how much the 52% tax would generate. End Note.)

Tax on Cash Deposits (IDE)

12.(U) The lower house approved the GOM's proposal to tax all cash deposits of at least 15,000 pesos (in a month) at a rate of 3 percent. The tax is currently 2 percent and only applies to deposits exceeding 25,000 pesos. The IDE will still be creditable against other taxes.

Internal PRI Power Struggle

13.(SBU) There is also an internal PRI political power struggle in the midst of the fiscal reform dispute. PRI senators are blaming interference of three PRI governors (Mexico, Oaxaca, and Veracruz) for putting pressure on the Senate to accept a tax package that would benefit the states. In Mexican economist Rogelio Ramirez de la O's view, the opposition is based on an internal party power struggle between Senator Manlio Fabio Beltrones and PRI President Beatriz Paredes. The rebels resent being left outside of an agreement between the GOM, some PRI governors, and Paredes who drove the decision to reach a compromise on taxes in the lower House. PRI senators will drop their objections to a compromise if they are included at the negotiating table for such agreements with the GOM. Ramirez de la O, however, notes that PRI senators - in order to save face - now need to further dilute the package. Paredes' international affairs advisor, Fausto Zapata, told Charge that this

spat should be manageable, especially in light of what he termed "the colossal ineptitude" of Cesar Nava. Nava's wrench in the works has given the PRI the upper hand in the negotiations with the GOM and that will likely produce PRI party unity.

14.(SBU) In addition, local businesses are lobbying the opposition to lower taxes on telecom services and to further relax the changes to the so-called "Fiscal Consolidation" rule. Some PRI senators are proposing to bring the VAT rate back to 15%, to lower taxes on telecom services, and to ease the fiscal consolidation rules. In order to offset the revenue loss, these senators propose increasing the projected oil price in next year's budget to $64/barrel and raising the budget deficit to 1% of GDP. This proposal, however, does not benefit the income transfers to the states. PRI members in support of stronger tax reform measures are concerned about the party's vulnerability in the ten state elections scheduled for next year. The PRI stands to win in at least seven of them.

¶15. (U) Any changes in the Senate must go back to the Chamber for approval. The lower Chamber now has until November 15 to approve the expenditure side of the budget. (Note: The Senate has no vote on the expenditure side. End Note.) President Calderon is unlikely to veto the expenditure bill, as he does not have sufficient votes in the Chamber of Deputies.

Comment

¶16. (SBU) The Chamber's version only covers the fiscal short-fall anticipated for 2010 by increasing the oil price assumption, incurring slightly more debt, and increasing taxes (but at lower rates than the GOM initially proposed). It is doubtful that the measures are strong enough to avoid a ratings downgrade, as they stop short of providing a long-term solution to falling public revenue and generating alternative income sources to replace the GOM's dependence on oil. Political, intraparty, and personal struggles in the Senate suggest further dilution of an already weak revenue package, increasing this likelihood of a downgrade. Observers have noted that in past years legislators have been given to similar theatrics and posturing. However, this year, as Mexico digs itself out of a recession and seeks to strengthen alternate revenue sources, the stakes are considerably higher.